

# Optimal Claims with Fixed Payoff Structure

C. Bernard\*, L. Rüschendorf†, S. Vanduffel‡

May 5, 2014

## Abstract

Dybvig [?] introduced the interesting problem of how to construct in the cheapest possible way a terminal wealth with desired distribution. This idea has induced a series of papers concerning generality, consequences and applications. As the optimized claims typically follow the trend in the market, they are not useful for investors who wish to use them to protect an existing portfolio. For this reason, Bernard et al. [?] impose additional state-dependent constraints as a way of controlling the payoff structure. The present paper extends this work in various ways.

In order to get optimal claims in general models we allow in this paper for extended contracts. We deal with general multivariate price processes and dismiss with several of the regularity assumptions in the previous work (in particular, we omit any continuity assumption). State-dependence is modeled by requiring that terminal wealth has a fixed copula with a benchmark wealth. In this setting, we are able to characterize optimal claims. We apply the theoretical results to deal with several hedging and expected utility maximization problems of interest.

**Key-words:** cost-efficient payoffs, optimal portfolio, state-dependent utilities

**AMS classification:** 91G10, 91B16

## 1 Introduction

We consider optimal investment problems in a financial market given by a market model  $S = (S_t)_{0 \leq t \leq T}$  in a filtered probability space  $(\Omega, \mathcal{A}, (\mathcal{A}_t)_{0 \leq t \leq T}, P)$ .  $S$  may

---

\*Carole Bernard, University of Waterloo, 200 University Avenue West, Waterloo, Ontario, N2L3G1, Canada. (email: [c3bernar@uwaterloo.ca](mailto:c3bernar@uwaterloo.ca)). Carole Bernard acknowledges support from NSERC.

†Ludger Rüschendorf, University of Freiburg, Eckerstraße 1, 79104 Freiburg, Germany. (email: [ruschen@stochastik.uni-freiburg.de](mailto:ruschen@stochastik.uni-freiburg.de)).

‡Steven Vanduffel, Vrije Universiteit Brussel, Pleinlaan 2, 1050 Bruxelles, Belgium. (email: [steven.vanduffel@vub.ac.be](mailto:steven.vanduffel@vub.ac.be)). Steven Vanduffel acknowledges support from BNP Paribas Fortis.

consist of several stocks and also bank accounts. Our basic assumption is that state prices at time  $t$  are determined by a pricing process  $\xi = (\xi_t)_{0 \leq t \leq T}$  that is adapted to the filtration. Typically,  $\xi$  will be the (discounted) pricing density process of a martingale pricing rule. Typical examples include exponential Lévy models in which one uses an Esscher pricing measure that has pricing process of the form  $\xi_t = g_t(S_t)$  and note that the case of the multidimensional Black–Scholes market is also covered herein. But one may also think of a stochastic volatility model in which  $\xi_t$  is a function of the process  $(S_u)_{0 \leq u \leq t}$  and some additional volatility process  $(\sigma_u)_{0 \leq u \leq t}$ .

Let  $X_T$  be a payoff at time  $T$  (i.e.,  $X_T$  is  $\mathcal{A}_T$ -measurable) with payoff distribution  $F$  and cost  $c(X_T) := E\xi_T X_T$ . The aim of an investor with law invariant (state-independent) preferences<sup>1</sup> is to construct a payoff  $X_T^*$  with the same payoff distribution  $F$  at lowest possible cost, i.e.

$$c(X_T^*) = \inf\{E\xi_T Y_T; Y_T \sim F\}, \quad (1)$$

where  $Y_T \sim F$  means that  $Y_T$  has the same payoff distribution  $F$  as  $X_T$ . Note that problem (??) depends only on the distribution  $F$  and not on the specific form of the payoff  $X_T$ . Therefore,  $X_T$  denotes in what follows any generic payoff with distribution function  $F$ .

The optimization problem in (??) represents the static version of the optimal portfolio problem (He and Pearson (1991a,b)). The optimal payoff can (in a second step) always be attained by hedging strategies in complete markets. Characterizations and sufficient conditions for representation of the optimal claims in incomplete markets by continuous time trading strategies have been established in the literature and are related to the optional decomposition theorem (see Jacka ?, Ansel and Stricker ?, Delbaen and Schachermayer ?, Goll and Rüschendorf ? and Rheinländer and Sexton ?).

The cost minimization problem in (??) has been stated and solved in various generality in Dybvig ?, Bernard, Boyle, and Vanduffel ?, Carlier and Dana ?, Rüschendorf ?, and others under various assumptions on the distributions. Several explicit calculations of optimal claims<sup>2</sup> have been given in the framework of the Black–Scholes Model (see Bernard et al. (2011,2014) ) and in exponential Lévy models (see Hammerstein et al. ?). In Section ??, we introduce the class of extended payoffs, which are based on the market information  $\mathcal{A}_T$  up to time  $T$  but also allow for external randomization. We refer to them as randomized payoffs. The use of randomization allows us to construct optimal claims explicitly without posing the regularity conditions as in Bernard et al. ?. Indeed, we provide a simple proof showing that optimal claims are only dependent on  $\xi_T$  and possibly on some independent randomization  $V$ . In the particular case of Lévy models this result implies path-independence of optimal claims, i.e. optimal claims are of the form  $X_T^* = f(S_T)$  resp.  $f(S_T, V)$ .

---

<sup>1</sup>Examples include lots of classical behavioral theories including mean-variance optimization (Markovitz ?), expected utility theory (von Neumann and Morgenstern ?), dual theory (Yaari ?), rank dependent utility theory (Quiggin ?), cumulative prospect theory (Tversky and Kahneman ?), and sp/a theory (Shefrin and Statman ?).

<sup>2</sup>We use in this paper the notion of payoffs and claims synonymously.

Bernard et al. [1, 2] point out that solutions to the cost minimization problem ([3]) are not suitable for investors who are exposed to some external risk that they want to protect against. These investors are prepared to pay more to obtain a certain distribution, simply because they want the optimal payoff to pay out more in some desired states. For example, a put option gives its best outcomes in the worst states of the market and thus allows investors to protect<sup>3</sup> the value of an existing investment portfolio that is long with the market. In other words, two payoffs with the same distribution do not necessarily present the same “value” for an investor; see also the discussion in Vanduffel et al. [4]. Therefore, in Section 5, we introduce and discuss, following the development in Bernard et al. [2], additional restrictions on the form of the payoffs. These restrictions are determined by fixing the desired copula of the claim with a random benchmark  $A_T$ . This type of constraint allows to control for the states of the economy in which the investor wants to receive payments. Note that in the case where  $A_T$  is deterministic there is no imposed restriction and we obtain again the optimal payoffs in the classical context without constraint. As a main result, we determine payoffs with minimal price and given payoff distribution  $F$  under state-dependent constraints in general markets. In comparison to the results in Bernard et al. [2] we obtain with the extended notion of (randomized) claims optimal solutions that are functions of  $\xi_T$ ,  $A_T$  and some independent randomization. This characterization extends the concept of ‘twins’ as optimal solutions as in Bernard et al. [2].

We use this characterization result to deal with several hedging and investment problems of interest. In Section 6, we provide the optimal claim for an expected utility maximizer with state-dependent constraints. In Section 7 we solve some optimal hedging problems and also determine the optimal contract for an expected return maximizer with constraints on the minimum and maximum desired return.

## 2 Randomized claims and cost-efficient payoffs

Denote by  $\mathcal{L}(\mathcal{A}_T)$  the class of all  $\mathcal{A}_T$ -measurable claims (payoffs) at time  $T$ . For the construction of optimal claims it will be useful to extend the notion of claims (payoffs) to randomized claims (randomized payoffs). We generally assume that the underlying probability space  $(\Omega, \mathcal{A}_T, P)$  is rich enough to allow to construct for each element  $Y_T$  a random variable  $V$  that is independent of  $Y_T$  and uniformly distributed on  $(0, 1)$ .

A ‘randomized claim’ is a claim of the form  $f(Y_T, V)$  involving a randomization  $V$  that is independent of  $Y_T$ . The use of randomized claims is an essential point in this paper, which allows to solve portfolio optimization problems in general market models. Under continuity assumptions as used in Bernard et al. [2] one can avoid this additional randomization. At first glance, it may seem strange to an investor to use an

---

<sup>3</sup>The same observation is also at the core of insurance business. People buy a fire insurance contract and not a cheaper financial contract with identical distribution (“digital option”) because the insurance contract provides wealth when it is actually needed; see also Bernard and Vanduffel [5].

independent randomization for the construction of an investment. A similar objection also concerned the use of randomized tests in classical testing theory. As in testing theory, where one obtains existence of optimal tests only in the class of randomized tests, one can expect existence of optimal claims only within the more general class of randomized claims. In some market models it may be possible to use the market model to construct this independent randomization. This is underlying the concept of twins in Bernard et al. ?, but in general the investor should be prepared to throw the dice in order to be better off. In what follows we use randomized claims without further ado.

For a given payoff distribution  $F$  a claim  $X_T^* \in \mathcal{L}(\mathcal{A}_T)$  with payoff distribution  $F$  is called ‘**cost-efficient**’ if it minimizes the cost  $c(Y_T)$  over all claims  $Y_T$  with payoff distribution  $F$ , i.e. if  $X_T^*$  solves (??) (see Bernard et al. ?). For the construction of cost-efficient payoffs we shall make use of the following two classical results:

**Hoeffding–Fréchet bounds** (Hoeffding ? and Fréchet ??): Let  $X, Y$  be random variables with distribution functions  $F, G$  and let  $U \sim U(0, 1)$  be uniformly distributed on  $(0, 1)$ . Then

$$EF^{-1}(U)G^{-1}(1 - U) \leq EXY \leq EF^{-1}(U)G^{-1}(U). \quad (2)$$

The upper bound is attained only if  $(X, Y) \sim (F^{-1}(U), G^{-1}(U))$  (where  $\sim$  refers to equality in distribution), i.e.  $X, Y$  are comonotonic. The lower bound is attained only if  $(X, Y) \sim (F^{-1}(U), G^{-1}(1 - U))$ , i.e.  $X, Y$  are anti-monotonic.

**Distributional transform** (Rüschendorf (1981, 2009)): For a random variable  $X \sim F$  and a random variable  $V \sim U(0, 1)$  that is independent of  $X$ , the ‘**distributional transform**’  $\tau_X$  is defined by

$$\tau_X = F(X, V), \quad (3)$$

where (with slight abuse of notation),  $F(x, \lambda) := P(X < x) + \lambda P(X = x)$  and note that  $F(x, \lambda) = F(x)$  when  $F$  is continuous. Then

$$\tau_X \sim U(0, 1) \quad \text{and} \quad X = F^{-1}(\tau_X) \text{ a.s.} \quad (4)$$

The variable  $\tau_X$  can thus be seen as a uniformly distributed variable that is associated to (or, transformed from)  $X$ .

For a payoff distribution function  $F$ , we denote by  $\mathcal{K}(F)$  the class of all claims that have payoff distribution  $F$ :

$$\mathcal{K}(F) = \{Y_T \in \mathcal{L}(\mathcal{A}_T); Y_T \sim F\}.$$

Combining the Hoeffding–Fréchet bounds in (??) and the distributional transform in (??) allows us to obtain in a straightforward way the following general form of the cost-efficient claim.

**Theorem 2.1** (Cost-efficient claim). *For a given payoff distribution  $F$  the claim*

$$X_T^* = F^{-1}(1 - \tau_{\xi_T}) \quad (5)$$

*is cost-efficient, i.e.*

$$c(X_T^*) = \inf_{Y_T \in \mathcal{K}(F)} c(Y_T) \quad (6)$$

*Proof.* The distributional transform  $\tau_{\xi_T} = F(\xi_T, V)$  is by (??) uniformly distributed on  $(0, 1)$  and  $\xi_T = F^{-1}(\tau_{\xi_T})$  a.s. This implies that the pair  $(\xi_T, X_T^*)$  is anti-monotonic and thus (??) is a consequence of the Hoeffding–Fréchet lower bound in (??).  $\square$

*Remark 2.2.*

1. When  $F_{\xi_T}$  is continuous, the additional randomization  $V$  can be omitted and (??) coincides with the classical result on cost-efficient claims (see Dybvig ?, Bernard et al. ?).

In the case that  $\xi_T = g_T(S_T)$  for an appropriate function  $g_T$  one obtains that

$$X_T^* = h(S_T) \quad (7)$$

for some function  $h$ . Thus any path-dependent option can be improved by a path-independent option. For this observation, see Bernard et al. ?.

2. Several explicit results on lookback options, Asian options and related path-dependent options have been given in the context of Black–Scholes models and Lévy models in Bernard et al. (2011,2014) and Hammerstein et al. ?.
3. It is not difficult to see (cf. the proof of Theorem ??) that optimal claims that follow from optimizing a law-invariant objective (e.g. expected utility) at a given horizon  $T$  must be cost-efficient.

### 3 Payoffs with fixed payoff structure

If  $\xi_T$  is a decreasing function of  $S_T$  (a property that is predicted by economic theory and confirmed by many popular pricing models including increasing exponential Lévy type models) then an optimized payoff  $X_T^*$  is increasing in  $S_T$ . The optimal payoff can thus be quite different from the initial payoff  $X_T$  and performs poorly when the market asset  $S_T$  reaches low levels. These qualitative features do not demonstrate a defect of the solution, but rather show that portfolio optimization which only considers distributional properties of terminal wealth is not suitable in all situations. For example, some investors buy put options to protect their existing portfolio (as a source of benchmark risk) and they are not interested in the cost-efficient alternatives as these are long with the market and do no longer offer protection. These observations let Bernard et al. ? to include constraints in the optimization problem that allow controlling for the states in which payments are received. In this paper, we build further on this development. We restrict the class of admissible options in the portfolio optimization problem by requiring that the admissible claims pay out more in some desired states (e.g. when  $S_T$  is low) and less in other states (state-dependence constraints).

To model the state-dependence constraints we use a random benchmark  $A_T$  and we couple the admissible claims  $Y_T$  to the behavior of  $A_T$ . More precisely, let  $A_T$  be some random benchmark such as e.g.  $A_T = S_T$  or  $A_T = (S_T - K)_+$  or some other available claim in the market and let  $C$  denote a copula which describes the wished

payoff structure of admissible claims. The copula  $C$  is not necessarily the copula of a given initial claim with the benchmark  $A_T$ , but it is a tool to describe in which states of the benchmark the investor wants to receive income (or protection). We consider a claim  $Y_T$  to be admissible if the copula of the pair  $(Y_T, A_T)$  is  $C$ , i.e.

$$C_{(Y_T, A_T)} = C. \quad (8)$$

The copula  $C$  determines how the payoff structure of  $Y_T$  is coupled to the benchmark  $A_T$ . In this way we are able to prescribe that payoffs are (approximately) increasing or decreasing in  $A_T$  or take place for  $A_T$  either big or small, as described by the following examples of copulas.

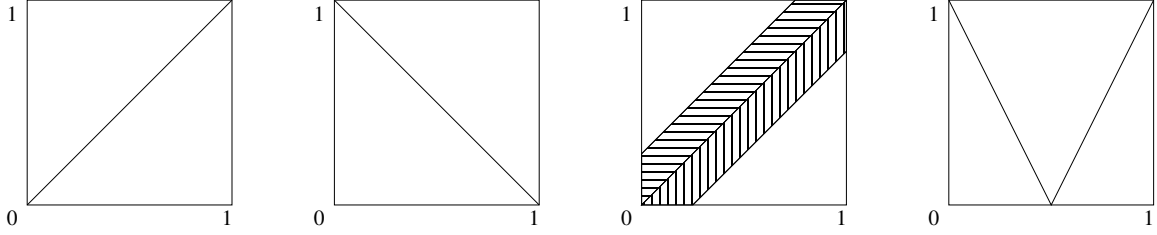


Figure 1: Various dependence prescriptions

The portfolio optimization problem in (??) is now modified to include a fixed payoff structure, i.e. we determine  $X_T^* \sim F$  with copula  $C_{(X_T^*, A_T)} = C$  such that

$$c(X_T^*) = \inf\{c(Y_T); Y_T \sim F, C_{(Y_T, A_T)} = C\}. \quad (9)$$

Since the joint distribution function  $G$  of  $(Y_T, A_T)$  is given by

$$G = C(F, F_{A_T}), \quad (10)$$

problem (??) is equivalent to the cost minimization problem when fixing the joint distribution of  $(Y_T, A_T)$  to be equal to  $G$ , i.e.

$$c(X_T^*) = \inf\{c(Y_T); (Y_T, A_T) \sim G\}. \quad (11)$$

For the construction of the solution of the portfolio optimization problem in (??) resp. (??) we will use the concept of the conditional distributional transform.

**Conditional distributional transform:** The conditional distributional transform of  $X$  given  $Y$  is defined as

$$\tau_{X|Y} = F_{X|Y}(X, V) \quad (12)$$

where for all  $y$ ,  $V$  is independent of  $(X|Y = y)$ .

It is clear that by property (??) of the distributional transform,

$$\tau_{X|Y} \sim U(0, 1) \text{ and } \tau_{X|Y} \text{ is stochastically independent of } Y. \quad (13)$$

In the following theorem we determine the optimal solution of the portfolio optimization problem in (??), (??). Based on the concept of randomized claims it gives an extension of Theorem 3.3 in Bernard et al. ? to the case of general market models (avoiding the regularity conditions imposed in that paper). Let  $X_T$  be a payoff with distribution  $F$  and such that  $(X_T, A_T)$  has copula  $C$ , or, equivalently,  $(X_T, A_T) \sim G$ .

**Theorem 3.1** (Cost-efficient claim with fixed payoff structure). *Let  $X_T$  be a claim with  $(X_T, A_T) \sim G$ , then*

$$X_T^* := F_{X_T|A_T}^{-1}(1 - \tau_{\xi_T|A_T}) \quad (14)$$

*is a cost-efficient claim with fixed dependence structure, i.e.  $X_T^*$  is a solution of the portfolio optimization problem with fixed payoff structure*

$$c(X_T^*) = \inf\{c(Y_T); (Y_T, A_T) \sim G\}.$$

*Proof.* Let us denote  $U = \tau_{\xi_T|A_T}$ . For  $X_T^* = F_{X_T|A_T}^{-1}(1 - U)$  holds

$$(X_T^* | A_T = a) = (F_{X_T|A_T=a}^{-1}(1 - U) | A_T = a) = F_{X_T|A_T=a}^{-1}(1 - U)$$

since  $U, A_T$  are independent (see (??)). Consequently, we obtain  $(X_T^*, A_T) \sim (X_T, A_T) \sim G$  and thus  $X_T^*$  is admissible. Furthermore, since conditionally on  $A_T = a$ ,

$$((X_T^*, \xi_T) | A_T = a) \sim ((F_{X_T|A_T=a}^{-1}(1 - F_{\xi_T|A_T=a}(\xi_T)), \xi_T) | A_T = a),$$

we obtain that  $X_T^*, \xi_T$  are anti-monotonic conditionally on  $A_T = a$ . This implies by the Hoeffding–Fréchet bounds in (??)

$$\begin{aligned} EX_T^* \xi_T &= EE(X_T^* \xi_T | A_T) \\ &\leq EE(X_T \xi_T | A_T) = EX_T \xi_T, \end{aligned}$$

i.e.  $X_T^*$  is cost-efficient in the class of portfolios with fixed dependence structure.  $\square$

*Remark 3.2.*

1. The proof shows that the cost-efficient claim with fixed dependence structure is characterized by the property that conditionally on  $A_T$  it is anti-monotonic with the state-price  $\xi_T$ . Note that Theorem ?? holds true in the case that  $C$  is any copula (not necessarily the copula of a given initial claim  $X_T$  with  $A_T$ ). The construction of  $X_T^*$  depends only on  $F$ ,  $A_T$  and on the copula  $C$ , i.e. the aimed payoff structure.
2. When the state-price  $\xi_T = g_T(S_T)$  is a decreasing function of the stock  $S_T$ , as in increasing exponential Lévy models, we obtain that a cost-efficient claim  $X_T^*$  is characterized by the property that conditionally on  $A_T$ ,  $X_T^*$  and  $S_T$  are comonotonic.
3. In the case that the independent randomization  $V$  can be generated from the market pair  $(S_t, S_T)$  by a transformation we obtain a cost-efficient claim of the form  $f(S_t, S_T)$  if  $A_T = S_T$ , resp.  $f(S_t, S_T, A_T)$  in the general case. Claims of this form are called ‘twins’ in Bernard et al. ?. It is shown in that paper that under some conditions cost-efficient payoffs are given by twins. With the notion of extended payoffs in this paper we obtain that generally optimal payoffs are of the form  $f(S_T, V)$  resp.  $f(S_T, A_T, V)$  with some independent randomization  $V$ .

## 4 Utility optimal payoffs with fixed payoff structure

The basic optimization problem of maximizing the expected utility of final wealth  $X_T$  at a given horizon  $T$  with an initial budget  $w$ , i.e.

$$\max_{c(X_T)=w} Eu(X_T) \quad (15)$$

was solved in various generality in classical papers of Merton ?, Cox and Huang ? and He and Pearson (1991a,b). The optimal solution for differentiable increasing concave utility functions  $u$  on  $(a, b)$  is of the form

$$X_T^* = (u')^{-1}(\lambda \xi_T), \quad (16)$$

where  $\lambda$  is such that  $c(X_T^*) = w$ . For the existence of  $\lambda$  such that  $c(X_T^*) = w$  it is assumed that  $u'$  is strictly decreasing and  $u'(a^+) = \infty$ ,  $u'(b^-) = 0$ .

An extension of the utility optimization problem to the case with a fixed payoff structure was introduced in Bernard et al. ? as

$$\max_{\substack{c(X_T)=w \\ C_{(X_T, A_T)}=C}} Eu(X_T) \quad (17)$$

To deal with problem (??), we define

$$Z_T = C_{1|A_T}^{-1}(1 - \tau_{\xi_T|A_T}), \quad (18)$$

where  $C_{1|A_T} = C_{1|\tau_{A_T}}$  is the conditional distribution function (w.r.t.  $C$ ) of the first component given that the second component is the distributional transform  $\tau_{A_T}$ . Then  $Z_T \sim U(0, 1)$ ,  $Z_T$  has copula  $C$  with  $A_T$  and the pair  $(Z_T, \xi_T)$  is anti-monotonic conditionally on  $A_T$  (see also (??)). Next, we introduce the following condition

(D)  $H_T = E(\xi_T | Z_T) = \varphi(Z_T)$  is a decreasing function of  $Z_T$ .

Condition (D) does not always hold but is natural since  $Z_T, \xi_T$  are anti-monotonic conditionally on  $A_T$ . In the strict sense it needs however some regularity condition to be fulfilled.

The following theorem describes the utility optimal payoff with fixed payoff structure and given budget  $w$  under condition (D).

**Theorem 4.1** (Utility optimal payoff with given payoff structure). *Under condition (D) the solution of the restricted portfolio optimization problem (??) is given by*

$$X_T^* = (u')^{-1}(\lambda H_T) \quad (19)$$

with  $\lambda$  such that  $c(X_T^*) = w$ .

*Proof.* The utility optimal payoff must be a cost-efficient claim with fixed payoff structure (with cost  $w$ ) as in Theorem ??. Otherwise, it is possible to construct a



strictly cheaper solution which yields the same utility while respecting the dependence constraint. Consequently the solution  $X_T$  (when it exists) is characterized by the property that conditionally on  $A_T$  it is anti-monotonic with the state-price  $\xi_T$  and, therefore,

$$X_T = F_{X_T|A_T}^{-1}(1 - \tau_{\xi_T|A_T}). \quad (20)$$

The payoff  $F_{X_T}^{-1}(Z_T)$  has distribution function  $F_{X_T}$ , has copula  $C$  with  $A_T$  and is conditionally on  $A_T$  anti-monotonic with the state-price  $\xi_T$ . By the uniqueness property of cost-efficient claims this implies that

$$X_T = F_{X_T}^{-1}(Z_T) \text{ a.s.}$$

In particular, the optimal solution is increasing in  $Z_T$  and the constraint on its cost can be written as

$$c(X_T) = E\xi_T F_{X_T}^{-1}(Z_T) = EH_T F_{X_T}^{-1}(Z_T), \quad (21)$$

where  $H_T = E(\xi_T | Z_T) = \varphi(Z_T)$  is decreasing in  $Z_T$  by assumption (D).

The utility optimization problem of interest can thus be rewritten as

$$\max_{\substack{EX_T H_T = w \\ X_T = k(Z_T) \\ k \text{ increasing}}} Eu(X_T). \quad (22)$$

Considering the relaxed problem

$$\max_{EX_T H_T = w} Eu(X_T) \quad (23)$$

we obtain an utility optimization problem in standard form with price density  $H_T$  instead of  $\xi_T$ . By (??) its solution is given by

$$X_T^* = (u')^{-1}(\lambda H_T) = (u')^{-1}(\lambda \varphi(Z_T)) \quad (24)$$

where  $\lambda > 0$  is chosen such that  $EH_T X_T^* = w$ . Since  $\varphi$  is decreasing by assumption (D) it follows that  $X_T^*$  is increasing in  $Z_T$  and thus it also solves the restricted portfolio optimization problem (??).  $\square$

Bernard and Vanduffel ? derive optimal mean-variance efficient portfolios in presence of a stochastic benchmark (Propositions 5.1 and 5.2). Their results also follow from Theorem ?? . An application of Theorem ?? in the univariate Black–Scholes model can be found in Bernard et al. ?. These authors use a Gaussian copula to fix the portfolio structure and verify that condition (D) is satisfied. Note that this example can be extended to the multivariate Black–Scholes model.

Interestingly, Theorem ?? can be extended to the general case without assuming condition (D). As a result the optimal claim will be slightly more complex. For the extension we need to project the function  $\varphi$  from the representation of  $H_T$  to the convex cone of decreasing  $L^2$ -functions  $M_\downarrow$  on  $[0, 1]$

$$M_\downarrow = \{f \in L^2[0, 1]; \ f \text{ non-increasing}\}.$$

Let  $\varphi \in L^2[0, 1]$ , supplied with the Lebesgue-measure and the Euclidean norm, and  $\hat{\varphi} = \pi_{M_\downarrow}(\varphi)$  denotes the projection of  $\varphi$  on  $M_\downarrow$ . Then we obtain

**Theorem 4.2** (Utility optimal payoff). *Assume that  $H_T = E(\xi_T \mid Z_T) = \varphi(Z_T)$  with  $\varphi \in L^2[0, 1]$ . Then the solution to the restricted utility optimization problem (??) is given by*

$$X_T^* = (u')^{-1}(\lambda \hat{H}_T), \quad (25)$$

where  $\hat{H}_T = \hat{\varphi}(Z_T)$  and  $\lambda$  is such that  $c(X_T^*) = w$ .

*Proof.* The proof is analogous to the proof of Theorem 5.2 in Bernard et al. ?. It is based on properties of the projection on convex cones which can be found in Barlow et al. ?.  $\square$

*Remark 4.3.*

1. The projection  $\hat{\varphi}$  of  $\varphi$  on  $M_\downarrow$  is given as the slope of the smallest concave majorant  $SCM(\varphi)$  of  $\varphi$ , i.e.  $\hat{\varphi} = (SCM(\varphi))'$ . Fast algorithms are known to determine  $\hat{\varphi}$ .
2. The condition  $\varphi \in L^2[0, 1]$  is implied by the condition  $\xi_T \in L^2(P)$ .

## 5 Optimal hedging and quantile hedging

In this section we use the results of Sections ??–?? to solve various forms of static partial hedging problems. Let  $L_T$  be a financial derivative (liability) and let  $w_L = c(L_T)$  denote the price of  $L_T$  w.r.t. the underlying pricing measure. If the available budget  $w$  is smaller than  $w_L$  then it is of interest to find a best possible partial hedge (cover) of  $L_T$  with cost  $w$  under various optimality criteria. This leads to the following basic static partial hedging problems.

The **quantile (super-)hedging problem** is defined as

$$\max_{c(X_T)=w} P(X_T \geq L_T). \quad (26)$$

The **utility optimal hedging problem** is a natural variant of (??) and is stated as

$$\max_{c(X_T)=w} Eu(X_T - L_T), \quad (27)$$

where  $u$  is a given concave utility function defined on  $\mathbb{R}$  that satisfies the same regularity conditions as in Section ??.

A more general version of the hedging problem in (??) is obtained by replacing expected utility by some law invariant, convex risk measure  $\Psi$  ( $\Psi$  monotonic in the natural order), i.e.

$$\max_{c(X_T)=w} \Psi(X_T - L_T). \quad (28)$$

We also consider (state-dependent) variants of the partial hedging problems (??)–(??) in which the excess  $X_T - L_T$  satisfies additional restrictions, allowing us to control its excess structure. For example, we may want that  $X_T - L_T$  has a certain copula

$C$  with a benchmark  $A_T$ , i.e.  $C_{(X_T - L_T, A_T)} = C$ , or we may impose certain additional boundedness conditions on  $X_T$ .

We start with the (unconstrained) optimal hedging problem (??). Its solution is given in the following proposition.

**Proposition 5.1** (Utility optimal hedge). *Let  $L_T$  be a financial claim with price  $c(L_T) = w_L$  and let  $w < w_L$  be the budget available for hedging. Then the optimal hedge for the utility optimal hedging problem (??) is given by*

$$X_T^* = L_T + (u')^{-1}(\lambda \xi_T), \quad (29)$$

where  $\lambda \geq 0$  is such that

$$c((u')^{-1}(\lambda \xi_T)) = w - w_L.$$

*Proof.* By the classical portfolio optimization result (see (??)) we obtain that the optimal solution of the utility optimization problem

$$\max_{c(X_T) = w - w_L} Eu(X_T) \quad (30)$$

is given by

$$\hat{X}_T = (u')^{-1}(\lambda \xi_T) \quad (31)$$

with  $\lambda$  chosen in such a way that  $c(\hat{X}_T) = E\xi_T \hat{X}_T = w - w_L$ . The claim  $X_T^* := \hat{X}_T + L_T$  therefore has price  $w$ ,  $c(X_T^*) = w$ . By definition  $X_T^*$  solves the utility optimal hedging problem in (??).  $\square$

In the following two extensions we fix the joint dependence structure of the excess  $X_T - L_T$  with a given benchmark  $A_T$ .

**Proposition 5.2** (Utility optimal hedge with dependence restriction on the excess). *Let  $L_T$  be a financial claim with price  $c(L_T) = w_L$ , let  $w < w_L$  be the budget available for hedging and let  $A_T$  be a given benchmark. Then the restricted utility optimal hedging problem*

$$\max_{\substack{c(X_T) = w \\ C_{(X_T - L_T, A_T)} = C}} Eu(X_T - L_T)$$

has the solution

$$X_T^* = L_T + (u')^{-1}(\lambda \hat{H}_T), \quad (32)$$

where  $\hat{H}_T = \hat{\varphi}(Z_T)$  and  $\lambda \geq 0$  is such that

$$c((u')^{-1}(\lambda \hat{H}_T)) = w - w_L.$$

*Proof.* The optimality of  $X_T^*$  is a consequence of Theorem ?? and is based on a simple replacement strategy as in the proof of Proposition ??.  $\square$

In the following variant of the hedging problem it is our aim to avoid super-hedging of  $L_T$ .

**Proposition 5.3** (Utility optimal hedge with negative excess). *Let  $L_T$  be a financial claim with price  $c(L_T) = w_L$  and let  $w < w_L$  be the budget available for hedging. The optimal hedge with lower bound constraint, i.e. the solution of*

$$\max_{\substack{X_T \leq L_T \\ c(X_T) = w}} Eu(L_T - X_T) \quad (33)$$

is given by

$$X_T^* = \min(L_T, L_T + (u')^{-1}(\lambda \xi_T)), \quad (34)$$

where  $\lambda \geq 0$  is such that

$$c((u')^{-1}(\lambda \xi_T)) = w - w_L.$$

*Proof.* With  $Y_T = L_T - X_T$  the hedging problem in (??) is reduced to the classical utility optimization problem in (??) with the additional constraints  $Y_T \geq 0$ . The solution of this problem is easily shown to be the classical solution  $Y_T^*$  restricted to this boundary. As consequence we obtain  $X_T^* = \min(L_T, Y_T^* + L_T)$  as in (??).  $\square$

When there are enough financial resources  $w > w_L$  available it might be of interest to obtain the best super-hedge  $X_T \geq L_T$ . We omit the details of the proof for this case.

**Proposition 5.4** (Utility optimal hedge with boundedness restriction on the excess). *Let  $L_T$  be a financial claim with price  $c(L_T) = w_L$  and let  $w > w_L$  be the budget available. The optimal super-hedge, i.e. the solution of*

$$\max_{\substack{L_T \leq X_T \\ c(X_T) = w}} Eu(X_T - L_T) \quad (35)$$

is given by

$$X_T^* = \max(L_T, L_T + (u')^{-1}(\lambda \xi_T)), \quad (36)$$

where  $\lambda \geq 0$  is such that

$$c((u')^{-1}(\lambda \xi_T)) = w - w_0.$$

The quantile super-hedging problem (??) was introduced in Browne ? for a deterministic target  $L_T$  in a Black–Scholes model. This result was extended in Bernard et al. (2013a, Theorem 5.6) to random targets  $L_T \geq 0$  under regularity conditions. The following proposition solves this problem without posing any regularity conditions.

**Proposition 5.5** (Quantile super-hedging). *Let  $L_T \geq 0$  be a financial claim with price  $c(L_T) = w_L$  and let  $w \leq w_L$  be the budget available. Then the solution to the quantile super-hedging problem in (??), i.e.*

$$\max_{\substack{0 \leq X_T, \\ c(X_T) = w}} P(X_T \geq L_T)$$

is given by

$$X_T^* = L_T \mathbf{1}_{\{\tau_{L_T \xi_T} < \lambda\}}, \quad (37)$$

where  $\lambda$  is such that  $c(X_T^*) = w$ .

*Proof.* The optimal solution  $X_T^*$  of (??) has a joint distribution  $G$  with the ‘benchmark’  $L_T$ . Thus from Theorem ?? we obtain that  $X_T^*$  is an optimal claim with fixed payoff structure. Therefore, conditionally on  $L_T$ ,  $X_T^*$  is anti-monotonic with the state-price  $\xi_T$  and is of the form  $X_T^* = f(\xi_T, L_T, V)$ , where  $V$  is some independent randomization.

We define the sets  $A_0 = \{f(\xi_T, L_T, V) = 0\}$  and  $A_1 = \{f(\xi_T, L_T, V) = L_T\}$ ; then  $P(A_0 \cup A_1) = 1$ , since in the other case it would be possible to construct an improved solution. In consequence we get that  $f$  can be represented in the form

$$f(\xi_T, L_T, V) = L_T \mathbb{1}_{\{h(\xi_T, L_T, V) \in A\}}$$

for some function  $h$  and measurable set  $A$ . Define  $\lambda > 0$  such that

$$P(\{h(\xi_T, L_T, V) \in A\}) = P(\{\tau_{L_T \xi_T} < \lambda\}).$$

Then  $\mathbb{1}_{\{h(\xi_T, L_T, V) \in A\}}$  and  $\mathbb{1}_{\{\tau_{L_T \xi_T} < \lambda\}}$  have the same distribution and further  $L_T \xi_T$  and  $\mathbb{1}_{\{\tau_{L_T \xi_T} < \lambda\}}$  are anti-monotonic. Thus by the Hoeffding–Fréchet lower bound in (??) we obtain

$$\begin{aligned} c(L_T \mathbb{1}_{\{\tau_{L_T \xi_T} < \lambda\}}) &= EL_T \xi_T \mathbb{1}_{\{\tau_{L_T \xi_T} < \lambda\}} \\ &\leq EL_T \xi_T \mathbb{1}_{\{h(\xi_T, L_T, V) \in A\}} \end{aligned}$$

and thus  $L_T \mathbb{1}_{\{\tau_{L_T \xi_T} < \lambda\}}$  is optimal. □

*Remark 5.6.* It was pointed out to the authors by a reviewer that the optimization results in Proposition ?? and Proposition ?? can be cast in an unconstrained optimization problem in Lagrangian form. For Proposition ?? this takes the forms

$$\sup_{X_T \geq 0} E(\mathbb{1}_{\{X_T \geq L_T\}} - \lambda \xi_T X_T) + \lambda w. \quad (38)$$

Under a continuity assumption a solution of (??) is achieved by  $X_T = L_T \mathbb{1}_{\{\lambda \xi_{L_T} < 1\}}$  with  $\lambda$  suitably chosen. The Lagrangian form in case of Proposition ?? is similar.

As a last application on hedging problems, we extend Proposition ?? by considering the combined case of a random claim  $L_T$  that needs to be hedged and the requirement that the hedging portfolio has some copula  $C$  with a random benchmark  $A_T$ .

**Proposition 5.7** (Quantile hedging with fixed payoff structure). *For a random claim  $L_T \geq 0$ , a benchmark  $A_T$  and a given copula  $C$ , the solution to the restricted hedging problem*

$$\max_{\substack{0 \leq X_T \\ c(X_T) = w \\ C_{(X_T, A_T)} = C}} P(X_T \geq L_T) \quad (39)$$

is given by

$$X_T^* = L_T \mathbb{1}_{\{Z_T \geq \lambda\}}, \quad (40)$$

where  $Z_T = C_{1|A_T}^{-1}(1 - \tau_{L_T \xi_T | A_T})$  and where  $\lambda$  is such that  $c(X_T^*) = w$ .

*Proof.* Let  $G$  be the joint distribution of the optimal claim  $X_T^*$  with  $A_T$ , then by the randomization technique in Section ?? there exists a claim of the form  $f(\xi_T, A_T, V)$  with a randomization  $V$  independent of  $(\xi_T, A_T)$ , such that

$$(f(\xi_T, A_T, V), A_T) \sim (X_T^*, A_T) \sim G \quad \text{and} \quad c(f(\xi_T, A_T, V), A_T) = c(X_T^*) = w.$$

Thus also  $f(\xi_T, A_T, V)$  is an optimal claim.

Defining as in the proof of Proposition ??  $A_0 = \{f(\xi_T, A_T, V) = 0\}$ ,  $A_1 = \{f(\xi_T, A_T, V) = L_T\}$  we get  $P(A_0 \cup A_1) = 1$  and thus there exist a measurable set  $A$  and a function  $h$  such that

$$f(\xi_T, A_T, V) = L_T \mathbb{1}_{\{h(\xi_T, A_T, V) \in A\}}.$$

Defining  $\lambda > 0$  by the equation

$$P(h(S_T, A_T, V) \in A) = P(Z_T \geq \lambda)$$

we obtain that  $\mathbb{1}_{\{h(\xi_T, A_T, V) \in A\}}$  and  $\mathbb{1}_{\{Z_T \geq \lambda\}}$  have the same distribution. This implies by the Hoeffding–Fréchet inequalities in (??) that

$$\begin{aligned} c(L_T \mathbb{1}_{\{Z_T \geq \lambda\}}) &= E \xi_T L_T \mathbb{1}_{\{Z_T \geq \lambda\}} \\ &\leq c(L_T \mathbb{1}_{\{h(\xi_T, A_T, V) \in A\}}) \end{aligned}$$

since conditionally on  $A_T$ ,  $Z_T$  is anti-monotonic with  $\xi_T L_T$  and thus  $\mathbb{1}_{\{Z_T \geq \lambda\}}$  is anti-monotonic with  $\xi_T L_T$ . This implies optimality of  $X_T^*$ .  $\square$

In the final application we consider the related problem of maximizing expected return with given cost and target bounds. For given bounds  $a < b$  we assume existence of a claim  $X_T$  such that  $a \leq X_T \leq b$  and  $c(X_T) = w$ .

**Proposition 5.8** (Maximizing expected return with given target bounds).  
*The solution of the expected returns maximization problem*

$$\max_{\substack{a \leq X_T \leq b \\ c(X_T) = w}} EX_T$$

is given by the payoff

$$X_T^* = a \mathbb{1}_{\{\tau_{\xi_T} > \lambda\}} + b \mathbb{1}_{\{\tau_{\xi_T} \leq \lambda\}} \tag{41}$$

with  $\lambda$  such that  $c(X_T^*) = w$ .

*Proof.* Assume that  $X_T^*$  is not an optimal payoff. Then there exists an admissible payoff  $Y_T$  such that  $EY_T > EX_T^*$ . We can then also find a strategy  $Y_T^*$  of the form

$$Y_T^* = a \mathbb{1}_{\{\tau_{\xi_T} > d\}} + b \mathbb{1}_{\{\tau_{\xi_T} \leq d\}}$$

with  $d$  chosen such that  $EY_T^* = EY_T$ . Since  $EY_T^* > EX_T^*$  it follows that  $d > \lambda$  and, therefore,

$$c(Y_T^*) = E \xi_T Y_T^* > c(X_T^*) = w.$$

On the other hand,  $Y_T$  is smaller than  $Y_T^*$  in convex order  $\leq_{\text{cx}}$ , i.e.

$$Y_T \leq_{\text{cx}} Y_T^*,$$

since  $Y_T^*$  has the same expectation and shifts all mass to the boundaries. Let  $\widehat{Y}_T = F_{Y_T}^{-1}(1 - \tau_{\xi_T})$  be the random variable with  $\widehat{Y}_T \sim Y_T$  and such that  $\widehat{Y}_T, \xi_T$  are anti-monotonic. Then from the Hoeffding inequality and the Lorentz ordering theorem (see Rüschendorf ?) we obtain

$$c(Y_T) = E\xi_T Y_T \geq E\xi_T \widehat{Y}_T \geq E\xi_T Y_T^* = c(Y^*), \quad (42)$$

using that  $\widehat{Y}_T \sim Y_T$  and thus  $\widehat{Y}_T \leq_{\text{cx}} Y_T^*$ . This leads to  $c(Y_T) > w$  and thus  $Y_T$  is not admissible. This contradiction implies the result.  $\square$

**Illustration of Proposition ?? in a Black–Scholes Market:** In the  $n$ -dimensional Black–Scholes market there is a (risk-free) bond with price process  $(S_t^0) = (S_0^0 e^{rt})$  and  $n$  risky assets  $S^1, S^2, \dots, S^n$  with price processes,

$$\frac{dS_t^i}{S_t^i} = \mu_i dt + \sigma_i dB_t^i, \quad i = 1, 2, \dots, n,$$

where the  $(B_t^i)$  are (correlated) standard Brownian motions, with constant correlation coefficients  $\rho_{ij} := \text{Corr}(B_t^i, B_{t+s}^j)$  ( $t, s \geq 0$ ;  $i, j = 1, 2, \dots, n$ ). Let  $\mu^T = (\mu_1, \mu_2, \dots, \mu_n)$ ,  $(\Sigma)_{ij} = \rho_{ij} \sigma_i \sigma_j$  and assume there exists  $i$  such that  $\mu_i \neq r$ . Let  $\Sigma$  be positive definite. Then the state-price takes the form (see e.g. Bernard et al. ?),

$$\xi_t = c \left( \frac{S_t}{S_0} \right)^{-d}, \quad (43)$$

where  $c = \exp \left( d \left( -\frac{\sigma^2}{2} \right) t - \left( r + \frac{(-r)^2}{2\sigma^2} \right) t \right)$  and  $d = \frac{\mu - r}{\sigma^2}$ . Here, the process  $(S_t)$  satisfies the SDE

$$\frac{dS_t}{S_t} = m dt + \sigma dB_t, \quad (44)$$

where  $(B_t)$  is the standard Brownian motion defined by  $B_t = \frac{\sum_{i=1}^n \pi_i \sigma_i B_t^i}{\sqrt{\pi^T \cdot \Sigma \cdot \pi}}$ ,  $m = r + \pi^T \cdot (\mu - r \mathbf{1})$ ,  $\sigma^2 = \pi^T \cdot \Sigma \cdot \pi$  and  $\pi = \frac{\Sigma^{-1} \cdot (\mu - r \mathbf{1})}{\mathbf{1}^T \cdot \Sigma^{-1} \cdot (\mu - r \mathbf{1})}$ . The process  $(S_t)$  is the price process that corresponds to a so-called constant-mix trading strategy (at each time  $t > 0$  a fixed proportion  $\pi_i$  is invested in the  $i$ -th risky asset).

We make the (economic appealing) assumption that  $> r$ . From Proposition ??, since  $\tau_{\xi_T}$  is decreasing in  $S_T$ , the optimal payoff is of the form

$$X_T^* = a \mathbf{1}_{\{S_T < \alpha\}} + b \mathbf{1}_{\{S_T \geq \alpha\}},$$

with  $\alpha$  such that  $E_Q \mathbf{1}_{\{S_T \geq \alpha\}} = \frac{we^{rT} - a}{b - a}$  where  $\frac{dQ}{dP} = e^{rT} \xi_T$ . It follows that  $\alpha$  is given as

$$\alpha = \exp \left( \left( r - \frac{\sigma^2}{2} \right) T - \sigma \sqrt{T} \Phi^{-1} \left( \frac{we^{rT} - a}{b - a} \right) \right).$$

## References

- Ansel, J.P., Stricker C. (1994) Couverture des actifs contingents, *Annales IHP*, Section B, 30, 303–315..
- Barlow, R.E., Bartholomev, D.J., Brenner, J.M., Brunk, H.D. (1972) *Statistical Inference under Order Restrictions*, Wiley.
- Bernard, C., Boyle, P.P., Vanduffel, S. (2014) Explicit representation of cost-efficient strategies, *Finance*, In Press.
- Bernard, C., Maj, M., Vanduffel, S. (2011) Improving the design of financial products in a multidimensional Black–Scholes market. *North American Actuarial Journal*, **15**, 77–96.
- Bernard, C., Moraux, F., Rüschendorf, L., Vanduffel, S. (2013a) Optimal payoffs under state-dependent constraints, *Preprint*.
- Bernard, C., Vanduffel, S. (2014a) Financial bounds for insurance claims, *Journal of Risk and Insurance*, In Press.
- Bernard, C., Chen, X., Vanduffel, S. (2013b). Optimal portfolios under worst-case scenarios, *Quantitative Finance*, In press, DOI:10.1080/14697688.2013.836282.
- Bernard, C., Vanduffel, S. (2014b). Mean–variance optimal portfolios in the presence of a benchmark with applications to fraud detection, *European Journal of Operational Research*, 234(2), 469–480.
- Browne, S. (1999) Beating a moving target: Optimal portfolio strategies for outperforming a stochastic benchmark, *Finance and Stochastics*, **3**, 275–294.
- Carlier, G., Dana, R.-A. (2011) Optimal demand for contingent claims when agents have law-invariant utilities, *Mathematical Finance*, **21**, 169–201.
- Cox, J.C., Huang, C.-F. (1989) Optimum consumption and portfolio policies when asset prices follow a diffusion process, *Journal of Economic Theory*, **49**, 33–83.
- Cox, J.C., Leland, H. (1982) On dynamic investment strategies, *Proceedings of the Seminar on the Analysis of Security Prices*, **26**, Center for Research in Security Prices, University of Chicago.
- Delbaen, F., Schachermayer, W. (1995) The no-arbitrage property under a change of numeraire, *Stochastics and Stochastic Reports*, **53**, 213–226.
- Dybvig, P. (1988) Distributional analysis of portfolio choice, *Journal of Business*, **61**, 369–393.
- Fréchet, M. (1940) Les probabilités associées à un système d’événements compatibles et dépendants; I. Événements en nombre fini fixe, volume 859 of *Actual. sci. industr. Paris*: Hermann & Cie.
- Fréchet, M. (1951) Sur les tableaux de corrélation dont les marges sont données, *Ann. Univ. Lyon, III. Sér., Sect. A*, **14**, 53–77.
- Goll, T., Rüschendorf, L. (2001) Minimax and minimal distance martingale measures and their relationship to portfolio optimization, *Finance and Stochastics* **5**, 557–581.
- Hammerstein, E.A.v., Lütkebohmert, E., Rüschendorf, L., Wolf, V. (2013) Optimal payoffs in multivariate Lévy markets, *Preprint*.
- He, H., Pearson, N.D. (1991a) Consumption and portfolio policies with incomplete markets and shortsale constraints. The finite dimensional case, *Mathematical Finance*, **1**, 1–10.
- He, H., Pearson, N.D. (1991b) Consumption and portfolio policies with incomplete markets and shortsale constraints. The infinite dimensional case, *Journal of Economic Theory*, **54**, 259–304.



- Hoeffding, W. (1940) Maßstabinvariante Korrelationstheorie, *Schriften des mathematischen Instituts und des Instituts für angewandte Mathematik der Universität Berlin*, **5**, 179–233.
- Jacka, S.D. (1992) A martingale representation result and an application to incomplete financial markets. *Mathematical Finance*, **2**, 239–250.
- Markowitz, H. (1952) Portfolio selection, *Journal of Finance*, **7**, 77–91.
- Merton, R. (1971) Optimum consumption and portfolio rules in a continuous-time model, *Journal of Economic Theory*, **3**, 373–413.
- Quiggin, J. (1993) *Generalized Expected Utility Theory – The Rank-Dependent Model*, Kluwer Academic Publishers.
- Rheinländer, T., Sexton, J. (2011) *Hedging Derivatives*, Advanced Series on Statistical Sciences & Applied Probability, Vol. 15, World Scientific
- Rüschendorf, L. (1981) Stochastically ordered distributions and monotonicity of the OC-function of sequential probability ratio tests, *Mathematische Operationsforschung und Statistik Series Statistics*, **12**, 327–338.
- Rüschendorf, L. (2009) On the distributional transform, Sklar’s theorem and the empirical copula process, *J. Stat. Planning and Inference*, **139**, 3921–3927.
- Rüschendorf, L. (2012) Risk bounds, worst case dependence and optimal claims and contracts, *Proceedings AFMATH Conference Brussel*, 23–36.
- Rüschendorf, L. (2013) *Mathematical Risk Analysis. Dependence, Risk Bounds, Optimal Allocations and Portfolios.*, Springer.
- Shefrin, H.M., Statman, M. (2000) Behavioral portfolio theory. *Journal of Financial and Quantitative Analysis*, **35**, 127–151.
- Tversky, A., Kahneman, D. (1992) Advances in Prospect Theory: Cumulative Representation of Uncertainty, *Journal of Risk and Uncertainty*, **5**, 297–323.
- Vanduffel, S., Chernih, A., Maj, M., Schoutens W. (2008) A note on the suboptimality of path-dependent payoffs in Lévy markets, *Applied Mathematical Finance*, **16**, 315–330.
- Vanduffel, S., Ahcan, A., Henrard, L., & Maj, M. (2012). An explicit option-based strategy that outperforms Dollar Cost Averaging. *International Journal of Theoretical and Applied Finance*, 15(02).
- Von Neumann, J., Morgenstern, O. (1947) *Theory of Games and Economic Behavior*, Princeton University Press.
- Yaari, M. (1987) The dual theory of choice under risk. *Econometrica*, **55**, 95–115.